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NOW IS THE TIME FOR TAX REFORM. CAN LD 1088 DELIVER?

by Kurt Wise

Taxes are central to our individual and collective well-being. Taxes provide the revenue that supports the physical infrastructure, the education, health care, and environmental protections that we have collectively decided are essential to keep our communities and families thriving. Still, the *way* government collects taxes has significant implications for the reliability and fairness of the system.

Maine's tax system is unnecessarily volatile. This volatility contributes to recurring budget shortfalls[1] and is exacerbated during economic downturns. While the Legislature has spent much of this session wrestling with large projected shortfalls caused primarily by the global economic crisis, discussion of tax reform as embodied by L.D. 1088 will figure prominently in the weeks ahead. This presents an important opportunity to assess our current tax structure with a view toward improving its efficacy and its fairness for all Maine people.

The Case for Reforming Maine's Tax Structure

When you don't have a reliable source of income, it is difficult to plan for the future. Unnecessary fluctuations in Maine's revenues routinely subjects lawmakers to this budgeting conundrum and undermines prudent investment in and delivery of beneficial programs and services. A key reason for these fluctuations is our over reliance on sales taxes that are applied to too narrow a list of items and that are driven by asset appreciation.

Professor Charles Colgan, Chair of Maine's Consensus Economics Forecasting Commission recently stated, "The bottom line is Maine's General Fund has been living off of asset price inflation over the last two decades…sales tax growth has been largely sustained by housing price growth. Essentially by using our houses as ATM machines, we were borrowing off of that rise in our asset value and using it to sustain consumption…(The State) raked in (sales taxes) when the housing ATM was open, and now that it's closed, we're taking a big hit."[2]

It is possible to restructure our tax system in Maine to achieve greater reliability and fairness.

This problem is compounded by Maine's over reliance on sales tax revenue collected from just two sources, auto sales and the sale of home building supplies. Together, these two sources supply roughly $300 million in annual revenues, or about one third of all the sales tax collected in Maine.[3] When the economy falls into recession – precisely the time when states are called upon to do most for their residents – auto and housing related sales tend to drop off sharply and leave sizeable gaps in the budget. Indeed, the latest data available from the Maine State Planning Office show that February auto sales are down 14% and building supplies sales are down by over 23% from a year ago, a further worsening from the dismal January figures.[4]

In order to maintain our important public investments, revenues should be less volatile and should allow government spending to keep pace with inflation. An important step Maine can take is to restructure the sales tax in such a way that is less subject to economic bubbles and is better connected to real economic activity and growth (State GDP). Part of the problem is that Maine's sales tax system is outdated, focusing heavily on taxing a narrow set of goods. An ever increasing percentage of total economic activity involves the purchase and sale of *services* rather than *goods*. Of the 168 categories of taxable services defined by the Federation of Tax Administrators, Maine taxes just 24.[5] By comparison, Connecticut taxes 80 of these services. If Maine followed suit, state revenues would climb by as much as $120 million annually.[6] Such an expansion also would ensure that Maine exports a larger share of taxes to nonresident visitors and tourists.

In addition to reducing the volatility of revenues, reforming Maine's tax structure can and should address important issues of fairness. Currently, Maine requires those with the least ability to pay to contribute the greatest share of their incomes to revenues. The lowest income households – people in the bottom 20% of earners – pay the highest percentage of their incomes toward state and local taxes (15%) while those Mainers with the highest incomes pay the least (9.4%). Tax reform provides an important opportunity to build a more progressive tax system – one in which the percentage of a household's income paid in taxes rises with increasing levels of income. This would be good both for Maine people and for the Maine economy.

Guiding Principles for Tax Reform

A new tax system must:

1. **Maintain adequate revenues to support essential government services and continue to grow at the rate of the overall economy.** If revenues cannot keep pace with growth in the economy as a whole, the inevitable result is that government services will be perpetually under-funded, and the need for constant rounds of budget cuts will become a mathematical certainty.
2. **Provide some benefit to all Maine residents.** These may include a mix of direct household tax reductions, simplification of the tax code, and the strengthening of Maine's present and future economic prospects.
3. **Target reductions to those who pay the greatest share of household income in taxes.** Currently, the lowest income households pay the highest percentage of their incomes toward state and local taxes and should benefit directly from any reform proposal.
4. **Export the costs of government to nonresidents as much as possible.** Thousands of short and long-term visitors come to Maine each year and use infrastructure and services that our tax dollars support. It is reasonable to expect that these visitors help defray a portion of these costs. Currently, nonresidents provide about 9% of all tax revenue generated in Maine.
5. **Maintain balance between taxes paid by households and businesses.** Individuals and businesses receive numerous direct and indirect benefits from public services and should therefore share in the cost of maintaining those services.

These principles were developed in 1994 by the Taxpayers for a Fair Budget Coalition. This group was instrumental in the formation of the Maine Center for Economic Policy. We believe any proposal to reform Maine's tax system should adhere to these principles.

A Proposal to Reform Maine's Tax System: LD 1088

A number of bills addressing overall tax reform are making their way through the Legislature. The one with the highest visibility, LD 1088, is sponsored by four-term representative and House Majority Leader, John Piotti.

The principal features of LD 1088 include:

- a broadening of the sales tax to include more services,
- modest increases in tax rates for several categories of goods and services used heavily by non-residents, i.e. meals, lodging and car rentals,
- the creation of a flat income tax rate set at 6.5%, which drops the current top rate from 8.5% and eliminates the 2% and 4% rates now applied to lower incomes.

To offset what otherwise would be a tax increase on lower income households resulting from the elimination of the 2% and 4% tax brackets and the broadening of the sales tax, LD 1088 includes a system of refundable household credits. These credits will reduce each filer's tax liability according to their income level, with lower income households receiving larger credits. If the credit reduces a filer's tax liability to less than zero, the state will provide a refund of up to seventy five dollars.

In addition to these three core features, LD 1088 seeks to maintain revenue neutrality, meaning that the state will collect neither more nor less revenues than it is projected to collect under the current system. By collecting more of our taxes from out of-state-visitors, LD 1088 also will reduce the taxes paid by Maine residents by some $75 million annually.

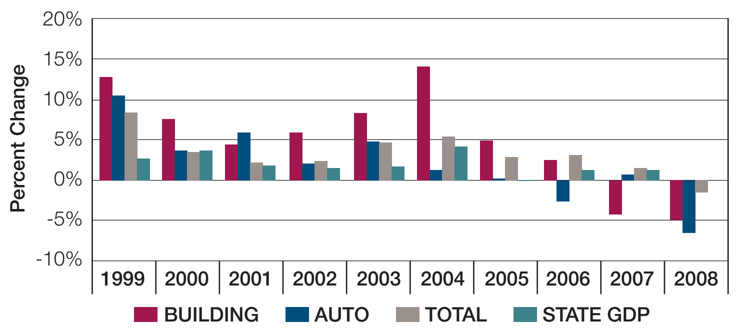
Applying the Guiding Principles to LD 1088

LD 1088 goes a long way toward satisfying three of MECEP's five guiding principles for tax reform. By broadening the sales tax in combination with overall revenue neutrality, LD 1088 seeks to maintain adequate state revenues and to ensure that revenue growth keeps pace with the Maine economy over the long term. This satisfies the first principle. As noted above, Maine Revenue Services estimates that LD 1088 also shifts some $75 million in taxes to visitors. Therefore, the fourth principle – exporting the costs of government to nonresidents – is achieved. Finally, LD 1088 spreads the $75 million in reduced resident taxes across all income groups providing some benefit to all Maine residents – principle two.

The effect of the bill on the fifth principle – maintaining a balance between taxes paid by households and businesses – is unclear and debatable. Naturally, many of the businesses that will have to collect more sales taxes such as those selling meals, lodging, and auto rentals testified against LD 1088 at recent public hearings held by the Joint Standing Committee on Taxation. Other businesses testifying against the bill included those that would have to collect sales taxes for the first time such as those offering recreation and amusements. On the other hand, some business owners, the Portland Chamber of Commerce, and the Androscoggin Chamber of Commerce favored the bill because of the benefits they believe will come from lowering the top income tax rate.

Of greatest concern is the degree to which LD 1088 may actually increase the net tax burden for low income households and thus run counter to the third principle – target reductions to those who pay the greatest share of household income in taxes. While LD 1088 proposes to give most households at every income level some reduction in their total taxes, the proposed refundable household credit may not deliver the promised results for all. The reason is that broadening the sales tax combined with the elimination of the 2% and 4% tax brackets for low-income households effectively *increases* rather than *decreases* the amount of taxes paid by these households. The mechanism to offset this increase is a state income tax refund. Because a significant number of low-income households in Maine, however, do not owe state *income* taxes, many are unlikely to file for such a refund. These households would pay more in sales and income taxes, but would not receive the offsetting credit. As a result, LD 1088's current design in fact may be somewhat regressive.

Building and Auto sales tax revenues are volatile compared to Total Maine sales tax revenues and State GDP



Source: Bureau of Economic Analysis, U.S. Department of Commerce
http://www.bea.gov/regional/gsp/default.cfm?series=NAICS

Improving LD 1088 for All Maine People

LD 1088 includes important elements of good tax reform. With modest revisions, the bill could be improved and deliver more of the proposed benefits to moderate and lower income Maine people. This can be achieved in two ways:

- Simplify the current property tax and rent relief program, known as the Circuit Breaker, and put the application into the state income tax forms
- Increase the state earned income tax credit (EITC) and make it fully refundable.

MECEP estimates the cost of these improvements to be between $10 and $20 million depending on how they are structured and the uptake rates. LD 1088 already offers over $30 million in tax relief to the top ten percent of Maine households by income. Thus, it would be possible to pay for these improvements and deliver significant benefit to ALL Maine households through a modest reduction in the proposed benefits going to Maine's highest income households. Such an approach would strike a better balance between a tax structure that is more reliable, rewards work and entrepreneurship, and achieves greater fairness for all taxpayers.[7]

Simplify and Integrate the Circuit Breaker

The Circuit Breaker program provides up to $2000 of relief to households with incomes below $80,000 per year whose property taxes exceed five percent of their income or whose rent exceeds 20% of their income. Currently, people must file an application for this refund separate from the forms submitted for income taxes. Maine Revenue Services estimates that less than half of eligible households participate in the program. Simplifying the filing process and incorporating the program directly into Maine's income tax structure would likely improve participation and better target tax relief toward moderate and lower income households.

Increase the state EITC and make it refundable

The state EITC is a program that provides tax relief to working families with incomes below $40,000. The ultimate benefit is based on the number of children in the home and the amount of income the family earns. The federal version of this program has earned widespread praise from researchers and lawmakers on both sides of the aisle for rewarding work and helping to keep working families out of poverty.

Maine's credit is capped at less than $250 per household, among the lowest credit levels of any of the 24 states with such a program. Maine's EITC is also non-refundable, meaning that once the credit has reduced a family's tax liability to zero, any remaining credit value goes uncollected by the family. Data from Maine Revenue Services shows that in 2006, some $1.85 million dollars went uncollected by 15,000 eligible filers due to non-refundability. As a result, many of Maine's poorest working families receive little or no benefit from the program. Making the credit fully refundable and increasing its value would direct meaningful support to working families and mitigate the potentially regressive elements of LD 1088.

Conclusion

Tax reform provides an important opportunity to improve the way we collect taxes. In Maine's case, it is possible to restructure our tax system to achieve greater reliability and fairness. LD 1088 is an important step in this direction and merits serious consideration by lawmakers on both sides of the aisle. However, some modification is necessary in order for LD 1088 to adhere to the guiding principles adopted by MECEP and its coalition partners. Such changes are both feasible and appropriate. Together with the core provisions of LD 1088, these changes will ensure that Maine people benefit from reliable infrastructure and services, and that Maine's tax burden is shared more equitably by all Mainers.

About the Author

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Endnotes

1 Spending growth is not the cause of Maine's ongoing budget woes. Maine's level of total state spending as a percent of total personal income (a rough measure of Mainers' ability to afford the government services they request) has increased very little over the last 10 years, rising from 14.15% in 1997 to 14.90% in 2008. Moreover, the percentage has declined steadily since 2004 and is almost certain to decline further over the next three years.
2 See link to his remarks at MECEP's Annual Conference webpage: http://www.mecep.org/MECEP2009TaxandBudgetConference.asp
3 Maine State Planning Office (SPO), "Maine Retail Sales Quarterly Report, Annual Review 2007"
4 SPO website: http://www.maine.gov/spo/economics/economic/retailsales.htm
5 See Issue Brief from the Center on Budget and Policy Priorities: http://www.cbpp.org/files/2-1-07sfp.pdf
6 Ibid
7 Much has been written about the relationship between lowering top income tax rates and the effect on business activity and mobility. While the notion that lower top rates will have a "trickle down" effect that will stimulate more economic growth and revenue has become a dominant idea in our political discourse, the empirical evidence directly contradicts this view. A survey by Robert Lynch of the Economic Policy Institute, for example, found little correlation between tax rates and business activities. Similarly, evidence from Ohio and New Jersey demonstrate that sharp increases in top income tax rates did not have significant impacts on patterns of mobility into or away from those states, particularly among top earners.

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